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In the Supreme Court of the United States

OCTOBER TERM, 1955

No. 249

JOSEPH E. SHEARER AND GEORGIA P. SHEARER, PETITIONERS

v.

JAMES G. SMYTH, UNITED STATES COLLECTOR OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The memorandum opinion of the District Court (R. 16-22) is reported at 116 F. Supp. 230. The *per curiam* opinion of the Court of Appeals (R. 103) is reported at 221 F. 2d 478.

JURISDICTION

The judgment of the Court of Appeals was entered on April 22, 1955. (Pet. App. ii.) The petition for a writ of certiorari was filed on July 20,

1955. The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254.

QUESTION PRESENTED

Whether, on the facts of this case, the two courts below were correct in finding that the property involved was held primarily for sale to customers in the ordinary course of the taxpayers' trade or business, with the consequence that the profits from the sale of such property were taxable as ordinary income and not entitled to capital gain treatment under Section 117 (j) of the Internal Revenue Code of 1939, as amended.

STATUTE AND REGULATIONS INVOLVED

Sections 22 and 117 of the Internal Revenue Code of 1939, and Section 29.117-1 of Treasury Regulations 111, are set out in the Appendix, *infra,* pp. 8-12.

STATEMENT

For many years, including the years 1945 and 1946, the taxpayers have been engaged in the real estate brokerage business in the San Francisco peninsula area. Taxpayer Joseph E. Shearer also devotes part of his time to farming. (R. 23.)

In February, 1939, the taxpayers purchased as community property 19.5 acres of unimproved land in the City of Atherton, California (hereinafter referred to as the Atherton Tract). They purchased this tract for three purposes: for use as a residence, for truck farming, and as a long-term investment. (R. 23.)

Taxpayers never built a residence for themselves on the property, and an ordinance adopted by the City of Atherton in 1939 precluded them from engaging in truck farming. Until 1944 they leased out the Atherton Tract for the growing of hay on a share-crop arrangement. The value of their share of the hay grown on the land during the lease was considerably less than the taxes assessed against the land. Thus, taxpayers lost money on the property during the period it was leased for the growing of hay. (R. 17, 24.)

In 1944, after taxpayer Georgia P. Shearer had become ill with pneumonia and was advised to live in the drier climate of Los Altos, taxpayers listed the Atherton Tract with two San Francisco brokers for sale as a unit. The only offer they received was for an exchange for an office building appraised at somewhat less than the price that had been paid for the property. (R. 17, 24.)

Approximately one year later, in 1945, the taxpayers learned that the City of Atherton planned to increase the minimum size of subdivision lots from 28,500 square feet to one acre per lot. They then decided to undertake a prompt subdivision of the Atherton Tract in order to maximize their profit from the sale of subdivided lots. (R. 17-18, 24.)

Taxpayers accordingly subdivided the Atherton Tract into 25 lots. Toward that end taxpayer Joseph Shearer, as manager of the community property, caused to be prepared the necessary sub-

division map; instructed the surveyor to lay out the subdivision on the basis of the minimum 28,500 square feet per lot; arranged for street paving, sewer installation, water lines and electricity; erected "For Sale" signs on the tract; obtained permits for smaller signs; printed sales maps for use by him and other brokers in the sale of the lots; and advertised in four newspapers for sales of the lots. He also spent considerable time in the actual selling of the lots, although some of the lots were sold by other real estate brokers. The total cost to the taxpayers of subdividing and selling the lots was in excess of $24,000. Of the 25 lots, 24 were sold before the end of 1946, and the profit to the taxpayers from the sale of these 24 lots was $34,254.72 after deducting from the total sales proceeds the apportioned cost of acquisition, subdivision and sales. (R. 24-25.)

On the basis of these facts, the District Court made its finding that, commencing in 1945 with the subdivision of the Atherton Tract, taxpayers held the property primarily for sale to customers in the ordinary course of their trade or business. Accordingly, the court concluded that the profits realized by the taxpayers from the sale of the lots were taxable as ordinary income and not as capital gains. (R. 25.) The Court of Appeals affirmed *per curiam*. (R. 103.)

ARGUMENT

The two courts below were correct in finding that the taxpayers held the lots in their subdivision pri-

marily for sale in the ordinary course of their business and that the profits on the sales should accordingly be taxed as ordinary income. The determination is essentially one of fact. Turning on the particular circumstances of this case, it presents no adequate ground for certiorari.

Whether property is held primarily for sale in the ordinary course of a business is, as the lower courts have uniformly recognized, a question of fact on which only clear error can justify reversal of the fact-finding tribunal. *Stockton Harbor Indus. Co.* v. *Commissioner,* 216 F. 2d 638 (C. A. 9), certiorari denied, 349 U. S. 904; *Smith* v. *Dunn* (C. A. 5), decided June 30, 1955 (1955 C. C. H., par. 9543); *Dougherty* v. *Commissioner,* 216 F. 2d 110 (C. A. 6); *Dillon* v. *Commissioner,* 213 F. 2d 218 (C. A. 8); *Home Co.* v. *Commissioner,* 212 F. 2d 637 (C. A. 10). The record demonstrates that there was no such error here. Without restating the facts, it may be noted that the District Court's determination was supported by the continuity and frequency of the sales involved; the sales of 24 pieces of property in a single year can hardly be characterized as isolated or casual transactions. Moreover, taxpayers' activities in subdividing the Atherton Tract, improving the lots, and conducting a sales campaign to dispose of them further buttress the finding that they had entered into the business of selling their real estate. (R. 24-25.) Regardless of the personal reasons which may have led taxpayers to engage in these activities, the

decisive point is that the lower courts could reasonably find, as they did, that the activities amounted to a business.

The lower courts' appraisal of the particular facts here affords no basis for establishing the conflict taxpayers assert with decisions of other Courts of Appeals and the Tax Court. *Phipps* v. *Commissioner,* 54 F. 2d 469 (C. A. 2); *Chicago Title & Trust Co.* v. *United States,* 209 F. 2d 773 (C. A. 7); *Dillon* v. *Commissioner,* 213 F. 2d 218 (C. A. 8); *United States* v. *Robinson,* 129 F. 2d 297 (C. A. 5); *Smith* v. *Dunn* (C. A. 5), decided June 30, 1955 (1955 C. C. H., par. 9543); *Schwerin Trust* v. *Commissioner,* decided March 11, 1954 (1954 P-H T. C. Memorandum Decisions, par. 54,069); and *Ellis* v. *Commissioner,* decided January 13, 1954 (1954 P-H T. C. Memorandum Decisions, par. 54,021). Each of these decisions was necessarily hinged upon the particular set of facts presented. While there have been occasional intimations of divergence in emphasis (see *United States* v. *Robinson, supra,* at 300), the variety of factual circumstances makes it impossible to perceive clear lines of irreconcilable difference in the legal standards applied.

It should be noted, moreover, that Section 1237 of the Internal Revenue Code of 1954 formulates new and detailed rules to assist in determining whether and to what extent profit from sales of lots in subdivisions is to be treated as ordinary income or capital gain. Applicable to sales after December 31, 1953, this provision sharply diminishes the

future importance of cases, like the one here, arising under the 1939 Code.

Accordingly, it has been determined that the Government will not seek certiorari in such recent Fifth Circuit cases as *Smith* v. *Dunn, supra* (invoked by taxpayers as inconsistent with the instant decision, Pet. 10), and *Goldberg* v. *Commissioner,* decided June 21, 1955 (1955 C. C. H., par. 9519), in which taxpayers prevailed in claiming capital gain treatment on the ground that the real property involved was not held primarily for sale in the ordinary course of a business. The considerations underlying this determination apply equally here and lead us to submit that further review in this case is not warranted.

CONCLUSION

For the reasons stated, it is respectfully submitted that the petition for a writ of certiorari should be denied.

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AUGUST, 1955.

APPENDIX

Internal Revenue Code of 1939:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income * * * from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; * * * or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

(26 U. S. C. 1952 ed., Sec. 22.)

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) *Definitions.*—As used in this chapter—

(1) *Capital assets.*—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used in the trade or busi-

ness, of a character which is subject to the allowance for depreciation provided in section 23 (l) * * *.

* * * * *

(j) [as added by Sec. 151(b) of the Revenue Act of 1942, c. 619, 56 Stat. 798, and amended by Sec. 127(b) of the Revenue Act of 1943, c. 63, 58 Stat. 21] *Gains and Losses from Involuntary Conversion and From the Sale or Exchange of Certain Property Used in the Trade or Business.*—

(1) *Definition of property used in the trade or business.*—For the purposes of this subsection, the term "property used in the trade or business" means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(l), held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Such term also includes timber with respect to which subsection (k) (1) or (2) is applicable.

(2) *General rule.*—If, during the taxable

year, the recognized gains upon sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets. * * *

* * * * *

(26 U. S. C. 1952 ed., Sec. 117.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

Sec. 29.117-1. *Meaning of Terms.*—The term "capital assets" includes all classes of property not specifically excluded by section 117(a)(1). In determining whether property is a "capital asset," the period for which held is immaterial.

The exclusion from the term "capital assets" of property used in the trade or business of a taxpayer of a character which is subject to the allowance for depreciation provided in section 23(l) and of real property used in the trade or business of a taxpayer is limited to such property used by the taxpayer in the trade or business at the time of the sale, exchange, or involuntary conversion. Gains and losses from the sale or exchange of such property are not subject to the percentage provisions of section 117(b) and losses from such transactions are not subject to the limitations on losses provided in section 117(d), except that under section 117(j) the gains and losses from the sale or exchange of such property held for more than six months may be treated as gains and losses from the sale or exchange of capital assets, and may thus be subject to such limitations. See section 29.117-7. Property held for the production of income, but not used in a trade or business of the taxpayer, is not excluded from the term "capital assets" even though depreciation may have been allowed with respect to such property under section 23(l) prior to its amendment by the Revenue Act of 1942. However, gain or loss upon the sale or exchange of land held by a taxpayer primarily for sale to customers in the ordinary course of his business, as in the case of a dealer in real estate, is not subject to the limitations of section 117(b), (c), and (d). The term

"ordinary net income" as used in these regulations for the purposes of section 117 means net income exclusive of gains and losses from the sale or exchange of capital assets.

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United States

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ADDENDUM TO PETITION FOR A WRIT OF CERTIORARI
to the United States Court of Appeals
for the Ninth Circuit.

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Contrary to the statement made by the respondent at page 6 of his brief in opposition to the granting of the writ, there is an absolutely irreconcilable difference between the legal standard applied in the Ninth

Circuit to the factual situation of subdivision and sale here presented and the legal standard applied in the other Circuits to comparable subdivision and sale factual situations. In the Ninth Circuit, the legal standard, set forth in *Palos Verdes Corp. v. U. S.*, CCA-9 (1952), 201 Fed. 2d 256, 259 is as follows: "If a real estate investment is liquidated by means of subdivision and sale, *the use of this method requires the conclusion* that the property is held for sale 'to customers in the ordinary course of trade or business.'" (See also, *Ehrman v. Commissioner*, CCA-9, 120 Fed. 2d 607, 610.) The Ninth Circuit's legal standard, as set forth in *Palos Verdes Corp.*, was applied by the two Courts below in deciding this case. (Printed Record, pp. 20-21.) In fact, at the hearing before the Court of Appeals for the Ninth Circuit, counsel for the petitioners was asked by the Court how he could hope to argue that the decision in *Palos Verdes Corp.* was not dispositive of the instant case; and counsel's argument that the two cases were clearly distinguishable on the basis of their dissimilar factual situations was given extremely short shrift. On the other hand, in the Second, Fifth, Seventh and Eighth Circuits, and in the Tax Court, there is no such legal rule that the use of the subdivision and sale method of liquidating an investment in real estate requires the conclusion that the property was held for sale "to customers in the ordinary course of trade or business". (See the analysis of the decisions in these other circuits, and in the Tax Court, appearing at pp. 7-13 of the petition for certiorari.) The legal

standard or test applied in these other circuits, and in the Tax Court, for determining whether a liquidation of an investment in real estate by means of a subdivision and sale constitutes an ordinary course of trade or business, is this: do the facts show such a continuity and regularity of engagement in real estate purchase, development, and sale activity and such a substantial expenditure of time in the transactions as to warrant the conclusion that the taxpayer is engaged in an ordinary course of trade or business as a dealer in real estate? Applying this legal standard or test to the facts in the instant case (see the statement of the case set forth in the petition), the decisions in prior cases involving comparable factual situations clearly indicate that there was not here a sufficient quantum of activity over a sufficient period of time to warrant the conclusion that the subdivision and sale of the Atherton acreage constituted an "ordinary course of trade or business".

Respondent, in his brief in opposition to the granting of the writ, states that the Government would itself have petitioned for writs of certiorari to the Fifth Circuit in two recent cases *on the very point here at issue,* except for the fact that a new statutory provision, not applicable until the taxable year 1954, sets forth new rules intended to diminish the future importance of the present conflict of authority on the question here presented. This amounts to an admission by the respondent that, in his opinion, there does presently exist the irreconcilable conflict of authority requisite for the granting of the writ.

The respondent's point that the newly-enacted statutory rules will diminish the future importance of the admitted conflict of authority on the question here presented is not well taken, for the following reasons:

1. The instant case involves the taxable year 1946. Undoubtedly hundreds, if not thousands, of cases involving this same question for the taxable years 1946-1953, inclusive, either now await decision or will arise for decision over many years to come. If certiorari on the question here presented is not granted, the law as applied to such cases in the Ninth Circuit will continue to conflict with the law as applied to such cases elsewhere in the United States.

2. The newly enacted rules are radically new, and do not enact into statutory law either of the conflicting legal standards now being applied by the Courts to the solution of the question here presented. Except for the fact that the new rules do indicate Congressional disapproval of the legal standard now being applied in the Ninth Circuit, they can be of no direct assistance in resolving the present conflict of authority.

Dated, San Francisco, California,
August 29, 1955.

WILLARD C. MILLS,
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